

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:RMC:DEN:TL-N-6411-97
AMHarbutte

date: April 28, 1999

to: Examination Division, Southern California District
Laguna Niguel CEG:1117
Attn: Linda Escalona, Team Coordinator

from: Regional Counsel, Western Region
Alice M. Harbutte, Special Trial Attorney, Denver, Colorado

subject: [REDACTED]
Form 906 Closing Agreement

This memorandum responds to your request for advice on the Closing Agreement, Form 906, between the Commissioner of Internal Revenue and [REDACTED] dated [REDACTED].

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is

to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

1. Whether the Service and a taxpayer may use a Closing Agreement, Form 906, to agree to a change in accounting method.

2. Whether the taxpayer and the Service, in the Form 906, Closing Agreement, dated [REDACTED], agreed to a change in the taxpayer's method of accounting with respect to [REDACTED].

3. Whether the Service may challenge the taxpayer's method of accounting for [REDACTED] in the current audit cycle.

CONCLUSIONS

1. Yes, a Closing Agreement may be used by the Service and a taxpayer to agree to a change in the taxpayer's method of accounting.

2. Yes, the Closing Agreement contains language which states that the parties are agreeing to correct the taxpayer's practice of reporting the income through the use of such accruals with respect to [REDACTED]. The agreement references section 481. This is an agreement by the parties to change the taxpayer's method of accounting with respect to how the taxpayer "uses certain reserves to account" for its [REDACTED]. The agreement is limited to the use of accruals/reserves to account for its [REDACTED]. The parties agreed that the taxpayer's practice was not appropriate. The parties set forth the appropriate adjustments to correct the reporting of the [REDACTED]. The parties did not explain the proper method of accounting to be used in this agreement. Extrinsic evidence may be used to determine the meaning of the agreement to the extent it is ambiguous.

3. Additional facts are necessary in order to determine whether the Service may challenge the taxpayer's present method of accounting for its [REDACTED] in the current audit cycle under examination. The facts surrounding the drafting of the closing agreement should be considered in determining the intent of the parties. This includes all correspondence between the taxpayer and the Service regarding the proper accounting for the [REDACTED].

FACTS

On [REDACTED], a Closing Agreement, Form 906, was executed on behalf of the Commissioner of Internal Revenue regarding [REDACTED]. A copy of this agreement is attached as Exhibit A. The agreement contains the following relevant provisions:

WHEREAS, Taxpayer maintains inventories and uses the accrual method of accounting;

WHEREAS, correction of this practice of reporting the income through the use of such accruals with respect to [REDACTED] is to be effected for the taxable years ended January 31, [REDACTED] and January 31, [REDACTED]; (emphasis added)

WHEREAS, in connection with such correction, an adjustment to the income of Taxpayer is required with respect to such [REDACTED]

NOW IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes that:

(1) There is a decrease of \$[REDACTED] in taxpayer's taxable income resulting from the correction of Taxpayer's practice of using certain reserves to account for its [REDACTED], and pursuant to IRC 481 such decreased shall reduce Taxpayer's gross income for each of the taxable years listed below in the amounts so stated: (emphasis added)

DISCUSSION

Issue 1:

The authority for the Service to enter into a Closing Agreement is found at I.R.C. § 7121 which provides at paragraph (a): The Secretary is authorized to enter into an agreement with any person relating to the liability of such person in respect of any internal revenue tax for any taxable period. Closing agreements are binding upon the parties as to the matters agreed upon and may not be annulled, modified, set aside, or disregarded in any suit or proceeding unless there is a showing of fraud, malfeasance, or misrepresentation of a material fact. I.R.C. § 7121(b); Rink v. Commissioner, 100 T.C. 319,323 (1993).

Revenue Procedure 68-16 explains the procedures applicable to the processing of a closing agreements.

Rev. Proc. 68-16, Section 7, paragraph .02 specifically states:

"Unambiguous Determinations Required. Determined matters should be stated with such clarity as to lead reasonably to only one interpretation. Although related documents, files, and testimony may be utilized in an attempt to explain the intent of the agreement, the agreement itself will be the primary basis for future action."

Rev. Proc. 68-16, Section 7, paragraph .03 provides:

"Matters Not Properly Determinable. Determinations should not attempt to fix tax treatment for future years where correct treatment will depend primarily on circumstances that will arise subsequent to the agreement, such as the application of capital gains treatment to future sales of real estate or the treatment of farm losses for future years."

While the Service generally does not use Forms 906 to agree to a change in accounting method, the Service is not prohibited from using a Closing Agreement to effect a change in method of accounting.

Issue 2:

Ordinary principles of contract law govern the interpretation of closing agreements. Smith v. United States, 850 F.2d 242, 245 (5th Cir., 1988); Rink v. Commissioner, 100 T.C. 319 (1993). Contract law principles generally direct that the parties look at the "four corners" of the agreement, unless it is ambiguous as to essential terms. Rink, 100 T.C. at 324.

The first question to be answered is whether the [REDACTED], Closing Agreement unambiguously states that the parties are agreeing to change the taxpayer's method of accounting. The agreement does not directly state that the parties are agreeing to a method of accounting change. However, there is strong language contained in the Closing Agreement which would support the taxpayer's argument that such a change was agreed upon.

First, paragraph (1) of the Closing Agreement references I.R.C. § 481. I.R.C. § 481 is entitled "Adjustments Required by Changes in Method of Accounting."

Second, paragraph (1) also provides that it is correcting the taxpayer's practice of using certain reserves to account for its [REDACTED].

Third, the first "Whereas" clause states that the taxpayer maintains inventories and uses the accrual method.

Fourth, the second "Whereas" clause states that the "correction of this practice of reporting income through the use

of such accruals with respect to Debit Memo Sales is to be effected for the taxable years ended January 31, [REDACTED] and January 31, [REDACTED]."

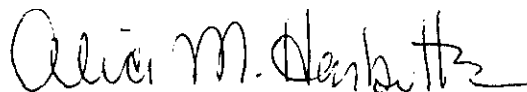
It is clear that the purpose of this Closing Agreement was to correct the method used by the taxpayer in reporting its [REDACTED]. The Closing Agreement specifically references I.R.C. § 481. Section 481 is entitled "Adjustments Required by Changes in Method of Accounting." If the parties were not agreeing to a change in method of accounting then why was section 481 referenced in the agreement.

Issue 3:

If the Closing Agreement is ambiguous "as to essential terms" then extrinsic evidence may be looked at to assist in determining the correct meaning of the agreement. The taxpayer will bear the burden of proving that its interpretation of any "ambiguous" contract language is the correct one. When each party intends a different meaning for an ambiguous term, no contract exists unless one party knew or had reason to know what the other party intended, 3 Corbin on Contracts, § 538 (1960). If one party knew or had reason to know what the other party intended, then the party with actual or imputed knowledge will be bound to the meaning intended by the other party. 2 Restatement, Contracts 2d, § 201 (1981). Evidence of the parties' subjective intent may always be considered in analyzing their respective interpretations. Evidence of surrounding facts and circumstances may be considered as well. Rink, 100 T.C. at 328.

The circumstances prior to and contemporaneous with the drafting of the closing agreement at issue in this case are relevant in determining what it means. The agreement is "ambiguous as to essential terms" in that it fails to state what the correct method of accounting is. In order to determine the scope of the agreement we need to look at all of the facts and circumstances surrounding the drafting of this Closing Agreement. This includes all correspondence between the taxpayer and the examination division pertaining to the drafting of this agreement.

If there are other facts or documents which you would like us to consider in connection with this matter please let us know. If you have any questions please call Special Trial Attorney Alice M. Harbutte at (303) 844-3258.



ALICE M. HARBUTTE
Special Trial Attorney